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C O N F I D E N T I A L SECTION 01 OF 04 CARACAS 000559

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TAGS: EPET ENRG EINV ECON VE
SUBJECT: THE NEW WINDFALL PROFITS TAX: ANOTHER FINE MESS

REF: A. CARACAS 108
¶B. CARACAS 491

Classified By: Acting Economic Counselor Shawn E. Flatt for Reason 1.4 (D)

¶1. (C) SUMMARY: The Official Gazette published the new windfall profits tax on April 15. The tax, which is seductively simple on its face, appears to place an unfair burden on private sector joint venture partners by allowing PDVSA to pass the tax to the joint ventures without allowing them a tax credit for their tax payments. The tax also places a significantly heavier burden on the producers of lower quality crudes. There is some question as to when the tax goes into effect. Private sector has been remarkably silent on the tax. END SUMMARY

IT SOUNDS SO SIMPLE

¶2. (C) The new windfall profits tax law, which was published in the Official Gazette on April 15, contains eight articles that appear to be straightforward. The first article states that the law imposes a special contribution on parties that export or transport abroad natural or upgraded liquid hydrocarbons. The special contribution is based on a formula that applies a 50% rate to the difference between the average monthly price of Brent crude and USD 70. When the average monthly price of Brent exceeds USD 100 a 60% rate is applied to the difference between the price and USD 100. The resulting amount is then multiplied by the monthly amount of natural or upgraded liquid hydrocarbons and derivatives exported from Venezuela. Energy Minister and PDVSA President Rafael Ramirez has stated publicly that the tax will raise the government's take to 91.7% when Brent is above 70 USD per barrel and to 96.7% when prices reach 100 USD per barrel. Article 4 of the law discussed below sets out the criteria for determining the monthly amount of exports.

¶3. (C) For example, the monthly average price of Brent crude in March, according to PDVSA, was 102.67 USD. (100 USD-70 USD) x .5 = 15 USD per barrel. (102.67 USD-100 USD) x .6 = 1.6 USD per barrel. As a result, the total tax would be 16.6 USD x the number of barrels exported.

¶4. (C) Article 2 permits the National Executive to grant total or partial exoneration for exports made under the "framework of economic policies and international cooperation". The article is widely interpreted to cover shipments made under the Petrocaribe program. Article 3 states the Energy Ministry will liquidate the contributions on a monthly basis in foreign currency and will pay the contributions to the National Development Fund (FONDEN). The law calls the payments "contributions" throughout, a word choice that permits the BRV to channel payment directly to FONDEN. Former Finance Minister Nelson Merentes told Econoff on April 21 that calling the payments "taxes" would legally imply that they must be paid to the central government, which in turn would be required to distribute part of them to states and other entities. Article 3 as written gives the National Executive complete discretion over the use of the funds.

¶5. (C) Article 4 states the monthly export amount will be determined by the dates and data on cargo certifications. Crude and derivatives that are imported into Venezuela for the purposes of blending or mixing may be deducted from the monthly export amount for the purposes of computing the tax.

¶6. (C) Article 5 permits parties to deduct contributions

that they have made to FONDEN from their windfall tax liability. Article 6 permits parties to count their windfall profits tax payments as costs for the purpose of computing their income tax.

¶7. (C) According to Article 7, the National Executive must use the proceeds from the new tax for "the execution of infrastructure development, production, and social development projects and the strengthening of communal power". President Chavez stated on April 13 that half of the proceeds would go to the new April 13 mission, which is tasked with raising the quality of life for the poor, and half would be used to complete the nationalization of the cement industry and the Sidor steel company. Article 8 states the law will go into effect on the date of its publication in the Official Gazette, which was April 15.

THE DEVIL IS IN THE DETAILS

¶8. (C) Despite its brevity and seeming simplicity, the windfall profits tax poses a myriad of problems for private sector oil companies operating in Venezuela. Every key element including who pays and the manner in which the tax is calculated is open to interpretation. On its face, PDVSA and the three joint ventures that produce and upgrade extra heavy crude in the Faja are the only entities that "export or transport" hydrocarbons. The rest of the joint ventures in Venezuela are required to sell all of their production directly to PDVSA under a series of marketing agreements. However, Energy Minister Rafael Ramirez stated this month that the joint ventures are subject to the tax since they are indirect exporters. A partner at the law firm of Macleod Dixon (strictly protect throughout) told Petroleum Attache (Petatt) on April 21 that the joint ventures' marketing agreements with PDVSA appear to include language that would allow PDVSA to discount the amount it pays as a windfall profits tax from the price that it must pay the joint ventures for their production. To make matters worse, the Macleod Dixon partner does not believe the joint ventures can deduct the amount of the windfall profit taxes from their income taxes since it is deducted from the amount of money

they receive for their production rather than a tax that is directly applied to them. A partner at the local law firm of Travieso Evans (strictly protect throughout) showed Petatt on April 22 a copy of Annex A of the marketing agreements. The annex contained language that clearly stated PDVSA could pass the tax on to the joint ventures via the pricing formula for crude sales. According to the attorney, the pricing formula in the annex was standard for all of the non-Faja joint ventures.

¶9. (C) The method of computing the tax is also fraught with complications. Despite the fact that the law clearly states on its face that the tax should be computed in two tiers as illustrated in paragraph 2, Energy Minister Ramirez has indicated that when the average price of Brent crude exceeds USD 100 the 60% rate should be applied to any revenue exceeding USD 70. If you apply Ramirez' formula to the example in paragraph 2, the total tax would be USD 19.60 (32.6 x .6) per barrel rather than USD 16.6.

¶10. (C) Regardless of the computation method, the tax is punitive in nature when it is applied to crude production that is significantly below Brent in terms of quality and price. The tax is applied to each barrel of oil regardless of its price. In the example given in paragraph 2, a tax of USD 16.6 is applied to each barrel of oil exported. As a result, the effective tax rate on a project that produces lower quality crude would be much higher than for projects

that produce lighter, sweeter crudes along the lines of Brent. Local analysts have noted Venezuelan production in some cases may be sold at 50% of Brent prices. Since the production in many of the joint ventures outside of the Faja produce lower quality crudes, the tax will have disproportionate impact on them.

¶11. (C) The method for determining monthly exports is also opaque. As the Macleod Dixon partner noted, cargo certifications are not a matter of public record. To make matters worse, it is not clear that PDVSA itself has a clear grasp of production and export figures. A BP employee told Petatt on April 19 that a PDVSA official in the central planning office told him that PDVSA officials in joint ventures frequently provide false production information to PDVSA in order to "meet" their production targets. An analyst told Petatt on April 21 that he has seen PDVSA internal documents that show a "fudge factor" in export figures. Even if PDVSA had correct production figures, it is not clear that their private sector partners in the joint ventures would have access to them. Contacts have told us in the past that PDVSA in some cases refuses to tell its private sector partners in joint ventures what the actual production is. In addition, since PDVSA handles marketing of the joint venture's crude oil, private sector partners have no way of knowing how much of the crude is destined for export versus the domestic market. Since the Faja joint ventures market their own crude, private sector partners should have a clear idea of what their tax liability is.

¶12. (C) The deduction for FONDEN contributions also raises a number of questions. According to local analysts, PDVSA contributed 6.76 billion USD to FONDEN in 2007 and is expected to contribute 10.4 billion USD in 2008. According to the analyst's figures, Brent crude would have to average more than USD 94.43 before PDVSA incurred any tax liability. Energy Minister and PDVSA President Ramirez has stated publicly that PDVSA contributions to FONDEN have averaged 6.7 billion USD over the past two years. The problem is that the National Executive can direct PDVSA at any time to divert its FONDEN contributions to another development fund or a series of missions. In addition, it is not clear if PDVDSA could still pass on all of the tax liabilities under the windfall profits tax to the joint ventures while reserving all of the benefits of the deduction for its own production.

WHEN DOES THE LAW ENTER INTO FORCE?

¶13. (C) As noted in paragraph 7, the law on its face states that it will enter into force on April 15. However, attorneys at Macleod Dixon have noted that the Venezuelan tax code states that levies, which the windfall profits tax is under Venezuelan law, must enter into force 60 days after publication in the Official Gazette. As a result, oil producers have the unpleasant task of deciding if they will comply with a provision that is clearly illegal.

BRV SHOOTS ITSELF IN THE FOOT (AGAIN)

¶14. (C) COMMENT: The new windfall profit tax strongly discourages future investment by the private sector, particularly in new extra heavy crude projects in the Faja. Since production from extra heavy crude fields occurs before the accompanying upgraders are built, early production is mixed with lighter crudes for marketing. Since the resulting blend is still much heavier than Brent crude, the windfall profits tax would sharply reduce the profit margin. Despite the BRV's constant drone about developing extra heavy crude

projects in the Faja, the windfall profits tax virtually removes any incentives for international oil companies to invest in new greenfield projects in the Faja.

¶15. (C) The tax also reveals the BRV's split personality when it comes to formulating oil policy. On the one hand, PDVSA has asked private sector oil companies and service companies to increase their investments in Venezuela. In addition, PDVSA officials have recognized they need the private sector if they are to increase production (Reftels A and B). On the other hand, the BRV has now effectively removed any incentive private sector oil companies have to invest in Venezuela.

¶16. (C) Both attorneys and analysts have commented to Petatt that they have been surprised that oil companies have quietly accepted the tax despite all of the problems that it poses. The private sector's silence may stem in part from a belief that the law will not have an effect on non-exporting joint ventures. We believe the private sector's silence on the windfall tax may also stem in part from the decision to stoically wait for the BRV's economic model to collapse. Once the model collapses, companies that have maintained a presence in Venezuela, despite all of the challenges, believe they will be ideally positioned to cut highly favorable deals with a Venezuelan government that is desperate to increase its oil revenues.

¶17. (C) Finally, the tax can also be viewed as an attempt by President Chavez to increase his personal control over a larger percentage of oil revenues. As noted in paragraph 4, the BRV faces institutional constraints on the use of taxes paid to the central government. FONDEN, an entity whose finances are even more opaque than PDVSA, does not have any such constraints. END COMMENT.

DUDDY